SEC Regulations Committee Highlights

Joint Meeting with SEC Staff - October 22, 1998

Location: SEC Headquarters – Washington, D.C.

NOTICE: The AICPA SEC Regulations Committee meets periodically with the staff of the SEC to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. The purpose of the following highlights is to summarize the issues discussed at the meetings. These highlights have not been considered and acted on by senior technical committees of the AICPA, or by the Financial Accounting Standards Board, and do not represent an official position of either organization.

In addition, these highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute an official statement of the views of the Commission or of the staff of the Commission.

I. **ATTENDANCE**

A. **SEC Regulations Committee**

Robert H. Herz, Chairman
Ernie Baugh
Mark Bagaason
Rusty Brinkman
Ed Coulson
David Einhorn
Wendy Hambleton
Jay Hartig
Amy Ripepi
Stewart Sandman
Bill Travis
Bill Yeates

B. **Securities and Exchange Commission**

Office of the Chief Accountant

Jane Adams, Deputy Chief Accountant
Jack Albert, Associate Chief Accountant
Scott Bayless, Associate Chief Accountant
Eric Casey, Professional Accounting Fellow
Pascal Desroches, Professional Accounting Fellow
Jeffrey Jones, Professional Accounting Fellow
Paul Kepple, Professional Accounting Fellow
Mike Kigin, Associate Chief Accountant
Robert Lavery, Assistant Chief Accountant
Leslie Overton, Assistant Chief Accountant
Richard Reinhard, Associate Chief Accountant

Bob Uhl, Professional Accounting Fellow

Division of Corporation Finance

Robert Bayless, Chief Accountant

Division of Investment Management

Paul Kraft

C. **AICPA**

Annette Schumacher Barr, Technical Manager

D. **Guests**

Kenny Chatelain, PricewaterhouseCoopers
Steve Swad, KPMG Peat Marwick
Carisa Wisniewski, Deloitte & Touche

II. PERSONNEL CHANGES

Jane Adams announced that Jenifer Minke-Girard will be joining the office as an assistant chief accountant in November. Jenifer's primary area of responsibility will be financial instruments.

III. PROPOSED REFORMS FOR SECURITIES OFFERINGS

Robert Bayless announced that the Commission has voted to issue for public comment proposed rules that would implement certain registration recommendations made by the Wallman Committee. It is expected that the proposed rules will be published in the Federal Register in late October. The public will have 120 days to comment on the proposal. Mr. Bayless distributed the press materials relating to the proposal. This document is included in these highlights as Attachment A.

IV. MARKET RISK DISCLOSURES

Pascal Desroches reported on the results of the staff's review of the required market-risk disclosures. The following list summarizes the staff's observations regarding weaknesses in disclosures made by some issuers:

- Failure to place the required qualitative and qualitative disclosures outside the financial statements and footnotes thereto (placing disclosures within the financial statements and their footnotes makes them ineligible for the safe-harbor provisions);
- Failure to state key assumptions, including future interest rates, when using the tabular presentation;
- Failure to properly group financial instruments by their common risk characteristics;
- Inadequate disclosure about the types of models that they used to measure

exposures; and

- Inadequate qualitative disclosures about how the entity manages its exposure to risk.

Mr. Desroches indicated that the staff will reconsider the accounting policy disclosure requirements. Robert Bayless noted that the staff expects that market events since the summer of 1998 will significantly impact issuer disclosures; for example, assumptions about possible movements in interest rates. He emphasized the requirements for disclosures about unusual instruments that may not be readily evident in the standard test of sensitivity.

V. AMENDMENTS TO RULE 102(e)

Mike Kigin noted that the final amendments to Rule 102(e) have been released and are available on the SEC's website (www.sec.gov). He provided a brief summary of the amendments, noting that "improper professional conduct" may be assessed through evidence of (1) intentional or knowing violations, including a reckless violation of applicable professional standards (e.g., GAAS) or (2) in certain instances, negligent conduct by a professional. Negligent conduct includes (1) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards under circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted or (2) repeated, unreasonable violations of applicable professional standards that demonstrate that the accountant lacks competence. Accountants who practice before the Commission are encouraged to read the rules, the adopting release, and Commissioner Johnson's dissent.

Mr. Kigin pointed out that the most controversial provision in the rule was that which defines improper professional conduct as a single instance of highly unreasonable conduct at a time when heightened scrutiny is warranted. The Committee asked whether the fact of an audit professional having had consulted his or her national office upon reaching an accounting conclusion might mitigate a charge of improper professional conduct. Mr. Kigin responded that consultation is one of a number of factors that the staff would take into account.

VI. CHAIRMAN LEVITT'S EARNINGS-MANAGEMENT INITIATIVES

The SEC staff led a discussion about the initiatives announced by Chairman Levitt in his speech of September 28 that he delivered at New York University. The following specific initiatives were discussed:

. Clarification of Schedule II Requirements

The Commission is expected to propose rules that will clarify when and at what magnitude Schedule II of Rule 12-09 of Regulation S-X, Valuation and Qualifying Accounts, should be provided. The staff will also consider whether investors give this information adequate attention in the schedules. The staff may consider recommending that the Commission require that this information be included in the notes to the financial statements or presented as a Regulation S-K disclosure. Amy Ripepi distributed an analysis summarzing the uncertainty among issuers and auditors regarding the types of valuation accounts that should be included in the schedule. This analysis is included as Attachment B to these highlights.

A. Issuance of Three New Staff Accounting Bulletins (SABs)

The staff expects to issue three new SABs addressing the following issues:

- Materiality - Both qualitative and quantitative factors will be considered. The staff is looking at information from relevant court cases that will help illustrate these factors.
- Revenue Recognition - Among other things, the SAB will describe the staff's views about accounting for "bill and hold" transactions (as described in AAER 108), as well as other recent registrant issues. The staff distributed a list of five questions that describe significant revenue-recognition issues. This list is included in these highlights as Attachment C.
- Asset Impairments and Restructuring Charges - Chairman Levitt described these as "big bath charges" taken by entities as one-time losses that make future earnings differences appear much better.

  In anticipation of the new SABs' issuance, the staff was asked what approach it plans to take with regard to financial statements filed prior to the issuance of the SABs. The staff responded that it is currently considering the need for transition guidance and evaluating what that guidance should say.

B. Collaborative Efforts with the AICPA

The staff will work with representatives of the AICPA in developing audit guidance on revenue-recognition matters. For example, the AICPA will prepare a "tool kit" of audit and accounting guidance on revenue recognition. The AICPA will also address revenue recognition issues in this year's Audit Risk Alerts. The Risk Alerts will incorporate concerns communicated in a public letter from Lynn Turner to Tom Ray of the AICPA staff. A copy of this letter is included in these highlights as Attachment D.

C. POB Audit Panel

In a September 28 letter from Lynn Turner to Al Sommer of the Public Oversight Board (POB), the staff requested that the POB examine whether recent changes in the audit process serve and protect the interests of investors. This letter is included in these highlights as Attachment E. As a result, the POB formed a panel of investors, auditors, audit committee members, corporate executives and others to study the effectiveness of the audit process. As part of this review, the POB will re-evaluate the peer-review process.

D. NYSE and NASD Blue Ribbon Panel on Audit Committees

The New York Stock Exchange and the NASD have formed a "blue ribbon" panel to recommend measures that will improve the effectiveness of audit committees.

VII. IN-PROCESS RESEARCH AND DEVELOPMENT

On September 9, Lynn Turner sent a letter to Bob Herz expressing concern regarding the valuation of acquired in-process R&D for the purpose of allocating the purchase price in a purchase business combination. As a result, an ad-hoc AICPA working group has been appointed to provide guidance on the issue. The letter is included in these highlights as Attachment F.

Bob Herz pointed out that the basic methodology traditionally used by the appraisal profession differs from the approach discussed in Lynn Turner's letter. Accordingly, the Committee is concerned that the staff may challenge the validity of allocations made prior to the issuance of Lynn's letter, and thus encourages the staff to "grandfather" those past practices. Robert Bayless responded that the staff's concern is not with the accounting standard, but about the reasonableness of the results of those allocations pursuant to the standard. He believes that in many cases the appraiser did not consider or become aware of all the relevant factors affecting fair value and therefore the appraisal was unreasonable. If the view of the staff is that the judgments applied in prior allocations were unrealistic, the staff will challenge the outcome.

Mr. Bayless stated that this issue is a matter of great alarm and concern to the staff and that the staff intends to pursue cases where reasonable judgement was not applied and to involve the Division of Enforcement when warranted.

VIII. 1998 AICPA SEC CONFERENCE

The Committee provided the staff with a number of topics that they may wish to consider addressing at the AICPA SEC Conference on December 8 and 9. Suggested topics include the following:

- FAS 131 - in particular, the aggregation criteria;
- FAS 133 reporting issues;
- Valuation of in-process R&D;
- Treasury stock and paragraphs 47c and 48c;
- Division of Enforcement views about mid-year consultations;
- Observations about plain-English disclosures;
- Pro-forma reporting;
- New rules on improper professional conduct;
- Earnings-management issues;
- Recent staff experiences with 10A reports;
- Year-2000 and the Euro conversion; and
- Restricted stock.

IX. EXCHANGE OF A BUSINSESS FOR AN EQUITY-METHOD INVESTMENT

The SEC staff discussed its views on accounting for the exchange of a division of an entity for stock in the acquiring entity in cases where the acquired shares would be accounted for by the equity method. The committee members indicated that, in practice, such exchanges are accounted for as book-value transactions (based on an interpretation of EITF Issue No. 86-29), rather than as fair value transactions (in accordance with APB 16). However, the SEC staff believes that this accounting is not in accordance with GAAP. The staff distributed a letter from Lynn Turner to Timothy Lucas at the EITF setting forth the staff's analysis as to why carryover basis accounting does not appear to be supportable under the authoritative literature and asking the EITF to address the issue. This letter is included in these highlights as Attachment G. Pending the EITF's resolution of this issue, the SEC staff will continue to hold the following views:

- The exchange of businesses must be accounted for as a fair-value transaction under APB 16, even if the subsidiaries are in the same line of business. The issue of what is a business is currently on the EITF agenda as Issue 98-3. The staff believes that the open interim question, as it relates to Issue 98-3, is whether or not the examples cited would all constitute businesses. Reference is also made to an SEC staff speech (given at the AICPA/SEC conference in December 1996) regarding exchanges of non-monetary assets.
- The exchange of a business for an interest in a joint venture would not typically result in gain recognition, absent the receipt of cash or near-cash consideration. The SEC staff's views are outlined in a speech that was given at the AICPA/SEC conference in January 1993, the text of which addresses gain recognition upon the formation of a joint venture.
- The exchange of a business for an equity-method investment in a company, where measurability and realizability would not be in question, must be accounted for as a fair value transaction.
- The guidance provided in SAB 48, as clarified by SAB 97, remains unchanged.

X. BUSINESS COMBINATIONS AND VALUATIONS

Jane Adams stated that the staff is close to finalizing its position regarding the AICPA's Business Combinations Task Force's white paper on systematic patterns. Other priorities have taken the staff's attention away from finalizing its positions on other issues previously discussed with the Committee, such as paragraph 48(c) dispositions, paragraph 47(c) alterations of equity interests, and valuations of cheap stock.

XI. ALLOWANCE FOR LOAN-LOSS RESERVES

Bob Uhl stated that the staff has observed a number of "red flags" that have raised concern about the size of loan loss reserves recorded by banks. For example, the staff has observed that a limited number of banks have reserves from eight to thirty times average current-period charge-offs and seven times the amount of non-performing assets. In addition, some foreign registrants or would-be registrants have indicated that they would need to increase their reserves to include expected future losses if they were to be brought in line with their U.S. counterparts.

The SEC staff recognizes that banks use a rating system to rank loans and then apply a historical charge-off ratio to those buckets as a starting point for the reserve. In addition, FAS 114 needs to be applied for impaired loans. The SEC is concerned, however, that a limited number of banks may also have a reserve for future losses or a reserve that may not be determined consistent with FRR 28. Finally, the staff notes that many annual-report disclosures indicate that times are good (non-performing loans are down, charge-offs are down, the economy is healthy, etc.), yet nothing is said about why - in light of these facts - a larger reserve than what might be expected is needed. Either the disclosures need to be enhanced or the allowance for loan-loss reserves is being overstated.

XII. IMPAIRMENT OF SECURITIES

The staff noted that during the recent market downturn, some sectors (such as foreign stock) have been hit especially hard. The staff reminds issuers that the carrying value of such securities must be written down through earnings if there is any chance that the decline in value is other than temporary. Issuers and auditors are reminded to consider SAB 59 and the relevant audit guidance on other-than-temporary declines.

XIII. INTERCOMPANY INTEREST-RATE SWAPS

The staff has seen instances in which a consolidated subsidiary hedges a risk exposure with the issuer's internal trading desk and the trading desk does not lay off the exposure to an outside party. The staff believes that intercompany transactions should not be accounted for as a hedge. The staff would like to receive input on this matter from issuers and auditors.

XIV. 1999 MEETING DATES

The Committee provided the Committee with its preliminary meeting schedule for 1999:

Wednesday, May 26
Tuesday, October 5

For Attachments A-G, send an e-mail with your name, address, phone and fax numbers to [secregs@aicpa.org].